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No. 97-533

Supreme Court, U.S.
FILED
NOV 6 1997
CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 1997

SHELL OIL COMPANY,
Petitioner,

v.

STUDIENGESELLSCHAFT KOHLE M.B.H.,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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PETITIONER'S REPLY BRIEF

JOHN D. NORRIS
Counsel of Record
RICHARD L. STANLEY
ARNOLD, WHITE & DURKEE
750 Bering Drive
Suite 400
Houston, Texas 77057
(713) 787-1400
Counsel for Petitioner
Shell Oil Company

Of Counsel:
A.M.T. FINCH, JR.
DEAN F. VANCE
SHELL OIL COMPANY
P.O. Box 2463
Houston, Texas 77252-2463
(713) 241-6161

November 6, 1997

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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Shell respectfully submits this reply brief to address the arguments in SGK's opposition, although SGK's opposition is more probative for what it does not say, for what it does not rebut, and for what it does not even try to defend. As shown herein, SGK's opposition mischaracterizes this Court's precedent and the record, and confirms that the Federal Circuit's precedential rule is flawed as a matter of law, policy, and logic.

SUMMARY OF THE REPLY

The reason that Shell's petition should be granted is straightforward. The rule announced by the Federal Circuit in this case—that a patent licensor may still pursue a contract action to recover unpaid license royalties after the licensed patent has been held invalid—is contrary to this Court's precedent, is misguided as a matter of federal patent policy, and is wasteful of scarce judicial resources as a matter of judicial administration. Where a patent licensee withholds royalty payments and is later sued by the licensor, proving invalidity of the licensed patent should remain a complete defense to the licensor's claims for royalty damages under any legal theory.

Just as proof that the licensed patent is not infringed provides a complete defense to a suit for unpaid license royalties, a licensee that satisfies the higher burden of proving that the licensed patent is invalid should obtain an equal benefit. Simply put, once the patent is held invalid, the court should leave the parties where it finds them. Absent fraud, the licensor keeps royalties already paid. At the same time, the licensee is freed from any further liability with respect to the invalid patent. There is no justification for allowing a licensor of an invalid patent to continue to litigate in search of an even greater undeserved windfall.

Presented in this case with a certified legal question of first impression for the Federal Circuit, that court was given the opportunity, as the court with exclusive jurisdiction over appeals arising under the patent laws, to reject an erroneous line of federal decisions stemming from the Sixth Circuit's decision in *PPG Indus., Inc. v.*

Westwood Chem., Inc., 530 F.2d 700, 703-07 (6th Cir.), *cert. denied*, 429 U.S. 824 (1976). Purporting to promote a nonexistent policy of encouraging early challenges to validity, those decisions allowed a licensor to recover unpaid royalties accrued between the time the licensee stopped making full royalty payments and the time that the licensee informed the licensor that the validity of the licensed patent was being challenged. By adopting rather than rejecting the rule created by the *PPG* line of cases, the Federal Circuit's decision has established that arbitrary, wasteful, and erroneous rule as the controlling law in federal district courts.

In doing so, the Federal Circuit violated this Court's landmark decision in *Lear v. Adkins*, 395 U.S. 653 (1969), which eliminated the doctrine of licensee estoppel and held that state contract law cannot provide a basis for recovering unpaid royalties under a license to an invalid patent. Yet, by authorizing SGK to pursue unpaid royalties after the relevant claims of its licensed patent have been held invalid, the Federal Circuit's rule means that licensees, such as Shell, are once again estopped by their license from using invalidity as a defense, at least prior to informing the licensor that its patent is deemed invalid. In practical effect, the Federal Circuit partially overruled *Lear*. Of course, only this Court is empowered to take such action.

I. THE FEDERAL CIRCUIT'S RULE IRRECONCILABLY CONFLICTS WITH THIS COURT'S LANDMARK DECISION IN *LEAR*

Somewhat predictably, SGK's first reason as to why this petition should be denied is its assertion that there is no conflict among the circuits that needs to be remedied. Brief in Opposition ("Opp.") 4-6. Not only is that assertion incorrect, *see* Petition ("Pet.") 27-30, but it completely ignores that the irreconcilable conflict is the one existing between this Court's decision in *Lear* and the line of federal court decisions that have adopted the erroneous "challenge" rule first announced in *PPG*.

Apart from urging that Shell's petition be denied, SGK offers no analysis that supports the Federal Circuit's rule. Instead, SGK merely recites conclusory passages (Opp. 4-5) from the very line of federal cases that Shell's petition demonstrated were wrongly decided in light of *Lear* and thus provide the central basis for granting this petition. SGK made no attempt to rebut Shell's showing that the supposed policy of encouraging early adjudications of patent invalidity is nowhere to be found in *Lear* or any other precedent of this Court. Pet. 24-27. Instead, SGK simply recites that policy as unilaterally announced by the Sixth Circuit in *PPG* as being the dispositive factor and assumes that recitation is enough to outweigh the contrary holdings of this Court.

SGK did not even attempt to rebut Shell's showing why the "benefits" identified by the Federal Circuit as allegedly flowing to licensees, such as Shell, from a license under an invalid patent, are illusory. Instead, SGK simply proclaimed that Shell received a "substantial benefit" in being free from an infringement suit during the period of the license. Opp. 7. However, because Shell never paid royalties for the polypropylene from its Seadrift process, any alleged freedom from suit was nonexistent with respect to that process. Pet. 20-21.

Like the Federal Circuit, SGK tries to justify that court's adoption of the "challenge" rule on grounds that Shell "avoided exposure" by allegedly breaching its contractual duty to inform SGK of the Seadrift production which Shell believed was not covered by the patent claims, and thus not by the license. Opp. 7-8. That alleged reporting breach, however, is not a legitimate basis for the Federal Circuit's ruling that Shell is potentially liable for back royalties, because Shell cured any such breach in accord with the license. *See* Pet. 8 at n.3. Indeed, SGK's breach of contract claim is based solely on Shell's nonpayment of royalties, not on an alleged failure to report its Seadrift production. App. 40a-41a. More importantly, for purposes of the rule of law urged by SGK and adopted by the Federal Circuit, Shell clearly did not avoid any

exposure to liability with respect to the Seadrift process for which Shell never paid royalties.

Contrary to SGK's assertion at Opp. 8, Shell did not concede that an alleged freedom from a "tort suit" rendered Shell liable under state contract law for all royalties that accrued while the Seadrift process was in operation until the license was terminated in 1993. Instead, Shell merely pointed out that if the license were truly not contingent upon patent validity, state contract law would require the licensee to pay all royalties for the entire contract term, whether or not the patent claims were subsequently held invalid—a result that even SGK had already conceded is not the law. *See* Pet. 18. Moreover, by restricting its assertion to alleged freedom from a "tort suit," SGK concedes that Shell had no freedom from a contract suit when royalties were not paid on its Seadrift process. *See* Opp. 8.

At least with respect to the post-challenge period, SGK implicitly agrees that something in *Lear* "requires that Shell's obligations under state contract law must be abrogated." *Id.* In actuality, there is nothing in *Lear* that suggests that a licensee's obligations under state law are only abrogated for the period after an express challenge to validity. That deadline is simply arbitrary, and has the erroneous effect of reinstating licensee estoppel prior to that time. Once a licensee withholds any royalties, the date upon which validity is later challenged should be legally irrelevant.

According to SGK, the artificial deadline reflects that *Lear* "merely requires that the licensee be permitted to challenge patent validity at an early time, so that the public stands to benefit if there is a determination of invalidity." Opp. 8. As demonstrated in Shell's petition, no such deadline or policy is found anywhere in *Lear*, and this Court clearly did not contemplate that post-issuance royalties could be recovered if the patent in *Lear* was held invalid on remand. Pet. 14-17. In explaining its rationale, this Court reasoned that a licensee "will have little incentive to initiate lengthy court proceedings, unless

he is *freed from liability at least from the time he refuses to pay the contractual royalties.*" 395 U.S. at 673-74 (emphasis added).

Moreover, this Court in *Lear* rejected an attempt to enforce a license provision that royalties were to be paid until such time as the patent was held invalid. *Id.* at 673. If such a provision was not enforced in *Lear*, the Federal Circuit clearly erred in allowing an alleged breach of a notice provision to justify recovering past due royalties on invalid patent claims. The mere existence of an ultimately cured breach cannot justify allowing state contract law to enable a licensor to seek past royalties for a license under an invalid patent. Such a result is clearly preempted by federal patent law and policy as repeatedly announced by this Court.

In this case, Shell accepted a license for its older processes and paid millions to SGK in royalties. Shell did not pay royalties on polypropylene made with its Seadrift process based on its belief that the new process was not covered by any claim of the '698 patent. When SGK later sued to obtain royalties on that process as well, Shell was "secure in the knowledge that invalidity may be urged when the patentee-licensor sues for unpaid royalties." *Blonder-Tongue Lab., Inc. v. Univ. of Ill. Found.*, 402 U.S. 313, 346 (1971). Shell did exactly that, proved invalidity by clear and convincing evidence, had that holding affirmed on appeal, and yet now finds itself back in district court with the further burden and task to demonstrate noninfringement. On its face, the Federal Circuit's rule violates the law established by this Court in *Lear* and later confirmed in *Blonder-Tongue*. *See* Pet. 15-16.

In *Cardinal Chem. Co. v. Morton Int'l, Inc.*, 508 U.S. 83, 100-01 (1993), this Court rejected the Federal Circuit's practice of routinely vacating district court decisions on patent validity upon affirming or reaching a finding of noninfringement. In doing so, this Court reiterated its view that "of the two questions, validity has the greater public importance" and noted that "the better practice"

is for district courts to inquire fully into the validity of the patent-in-suit. *Id.* at 100 (quoting *Sinclair & Carroll Co. v. Interchemical Corp.*, 325 U.S. 327, 330 (1945)).

In addition, this Court in *Cardinal* again emphasized "the importance to the public at large of resolving questions of patent validity." 508 U.S. at 100 (citing *Blonder-Tongue*). Yet, here, the Federal Circuit's rule has the effect of penalizing the first party to prove invalidity of the patent claims, purportedly because that party did not do so sooner. This Court should not allow the Federal Circuit to create another misguided rule that encourages defendants and district courts to avoid litigating and resolving the issue of patent validity.

As explained in Shell's petition, if invalidity does not provide a complete defense to a claim for unpaid royalties, licensees will focus their attention on proving non-infringement, whenever possible, because of its lower burden of proof and the ability to gain a complete defense. Pet. 23-24. As in *Cardinal*, the net result of such a rule will be to prolong the life of invalid patents. 508 U.S. at 102. Not only will that not benefit the public, but unlike situations where patent validity at least remains in doubt, the Federal Circuit's rule as announced in this case allows a licensor to seek even greater unwarranted rewards for patent claims that already have been finally adjudicated to be invalid.

II. BY ERRONEOUSLY FOLLOWING ITS OWN DECISION IN *DIAMOND SCIENTIFIC*, THE FEDERAL CIRCUIT IMPERMISSIBLY EQUATED ASSIGNOR ESTOPPEL AND LICENSEE ESTOPPEL AND EFFECTIVELY OVERRULED THIS COURT'S HOLDING IN *LEAR*

SGK's opposition did not even try to defend the Federal Circuit's improper end run around *Lear* based on its inapt reliance on its own decision in *Diamond Scientific Co. v. Ambico, Inc.*, 848 F.2d 1220 (Fed. Cir.), *cert. dism'd*, 487 U.S. 1265 (1988). As Shell pointed out (Pet. 19-20), the Federal Circuit carefully sidestepped *Lear* in reaching its decision in *Diamond Scientific* to

resurrect assignor estoppel, by drawing an explicit distinction between an assignor and a licensee:

> The public policy favoring allowing a licensee to contest the validity of the patent is not present in the assignment situation. Unlike the licensee, who, without *Lear*, might be forced to continue to pay for a potentially invalid patent, the assignor who would challenge the patent has already been fully paid for the patent rights.

848 F.2d at 1224. However, the Federal Circuit conveniently ignored that distinction in the present case when it relied on *Diamond Scientific* to legitimize SGK's contract suit for royalties under a license to an invalid patent—in violation of *Lear*.

Unable to provide any plausible justification for how the Federal Circuit could legitimately distinguish licensee estoppel in *Lear* from assignor estoppel in *Diamond Scientific* and then rely on *Diamond Scientific* to allow a partial return to licensee estoppel in this case, SGK does not even cite or mention *Diamond Scientific* in its opposition. Such conspicuous silence should make it clear to this Court that Shell's petition is well taken and should be granted. On its face, neither the Federal Circuit's legal bootstrapping to avoid this Court's decisions nor its resulting legal conclusion in conflict with this Court's holdings can be supported or condoned.

A fundamental issue underlying this petition is whether federal courts should feel free to ignore or distinguish decisions of this Court as long as they remain in agreement with the result or rationale of the first circuit court to do so. Presumably, this Court expects its decisions to be followed. Thus, the failure of a number of the federal circuits to adhere to this Court's precedent in *Lear* and *Blonder-Tongue* should be a compelling reason to grant Shell's petition in this case, not a reason for denying it and thus allowing licensee estoppel to be reinstated over time in the same manner that the Federal Circuit unilaterally restored assignor estoppel in *Diamond Scientific*.

Shell's petition also provides this Court with the opportunity to clarify whether the privilege of overruling Su-

preme Court decisions related to patent law and announcing federal patent policy remains the province of this Court, or whether the Federal Circuit is now free to do as it pleases when faced with a patent precedent of this Court with which it disagrees. In this case, the Federal Circuit's opinion expressly dismissed this Court's decision in *Lear* as merely a by-product of "tones that echo from a past era of skepticism over intellectual property principles." App. 12a.

In its petition, Shell outlined the Federal Circuit's own summary of its repeated efforts to avoid *Lear* in its decisions prior to this one. Pet. 8-9 at n.4; App. 12a-13a. Up until now, this Court has not been given a chance to review those prior Federal Circuit decisions undermining *Lear*. If this Court is willing to stand idle while one of its leading patent decisions is progressively limited to its facts, as the Federal Circuit has already done by distinguishing or sidestepping *Lear* at every opportunity, then it makes a mockery of this Court's practice of only granting certiorari in cases with widespread significance to the development of the law.

If a landmark opinion such as *Lear* is to be overruled or limited, such action should be taken by this Court, not by the Federal Circuit or by any regional circuit. At a minimum, such bold action by the lower federal courts should be expressly approved by this Court. While Congress created the Federal Circuit in 1982 to bring uniformity to the patent laws, Congress presumably left final review of the Federal Circuit's patent decisions in the hands of this Court for a reason. *See Cardinal*, 508 U.S. at 97 ("the Federal Circuit is not a court of last resort").

In *Lear*, this Court completely eliminated the doctrine of licensee estoppel and recognized that patent invalidity would be a complete defense to a licensor's claim for unpaid royalties. By granting this petition, this Court will be able to reaffirm that the patent issues already decided by its opinions remain the final pronouncements as to federal patent policy unless and until changed by this Court.

III. THE FEDERAL CIRCUIT'S RULING ON THE QUESTION PRESENTED CANNOT BE ALTERED BY THE DISTRICT COURT AND WILL REMAIN THE CONTROLLING PRECEDENT IN PATENT LICENSE CASES UNLESS THIS PETITION IS GRANTED

Finally, SGK resorts to the ploy of all oppositions to petitions for certiorari in arguing that "any decision of this court, on the question presented, may turn out to be no more than *dictum* in this action" because the case has been remanded to the district court for trial on various issues. Opp. 1. More so than in most cases, SGK's argument is utterly misplaced.

The question presented by Shell's petition was certified for appeal under 28 U.S.C. § 1292(b) because it was a controlling question of law whose immediate resolution would prevent the district court from having to conduct an extensive infringement trial unnecessarily. *See* App. 33a. Because the conflict between this Court's decision in *Lear* and the erroneous "challenge" rule created by the post-*PPG* decisions in the regional circuits had never been addressed by the Federal Circuit, that court could have clarified the law and resolved any confusion without the involvement of this Court.

Now that the Federal Circuit has become the latest federal appellate court to deviate from this Court's precedent, the need to resolve correctly and conclusively the legal issue as to whether unpaid license royalties can be recovered by the licensor after the licensed patent is held invalid has not diminished. If anything, it has now become even more critical for this Court to resolve that important legal question now, in this case, once and for all. If the Federal Circuit's decision is allowed to remain the law of the land, district courts across the country will be forced to waste scarce judicial resources adjudicating infringement of patents that have already been held to have no valid scope.

SGK also asserts that "the district court will never be required to address the question presented herein" if Shell

prevails on its defense that it did not infringe invalid claim 1 of the '698 patent. Opp. 6. With all due respect, that assertion is absurd. The question as to whether a district court would have to decide whether royalties are due on the invalid patent is exactly the legal issue that was certified for appeal by the district court, and exactly the issue that has already been decided by the Federal Circuit. On remand, the district court has no ability or discretion to deviate from that mandate. With the relevant claims of the patent already affirmed as invalid, the district court has no choice but to resolve whether SGK's invalid patent was infringed by Shell, unless Shell's petition is granted.

If SGK is actually arguing that this Court should decline to hear Shell's petition at this stage of the case because the district court could still decide on remand that Shell does not owe any license royalties for the "pre-challenge" period in question, that suggestion is disingenuous. If Shell does not or cannot raise this issue after final judgment because it prevailed on noninfringement or any of its other defenses, this Court's best chance to review the erroneous rule mandated by the Federal Circuit's precedential opinion in this case will be lost and all district courts hearing patent cases will be bound by that wasteful rule.

Simply put, a licensor should not be allowed to use state contract law to pursue unpaid royalties after the licensed patent has been held invalid. Shell's petition for writ of certiorari should be granted to make clear that there should *never* be a remand for further proceedings to determine liability for unpaid royalties under a license to an invalid patent.

Respectfully submitted,

JOHN D. NORRIS
Counsel of Record
RICHARD L. STANLEY
ARNOLD, WHITE & DURKEE
750 Bering Drive
Suite 400
Houston, Texas 77057
(713) 787-1400
Counsel for Petitioner
Shell Oil Company

Of Counsel:
A.M.T. FINCH, JR.
DEAN F. VANCE
SHELL OIL COMPANY
P.O. Box 2463
Houston, Texas 77252-2463
(713) 241-6161

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